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Intellectual Origins of Indian Economic Reform: A Review of Jagdish Bhagwati's *India in Transition: Freeing the Economy* (1993)

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India at last has succeeded in shaking off its proverbial drift and has begun a well-orchestrated effort beginning in mid-1991 to reach its economic potential, which its admirers had hoped for but its politicians and economists resisted over the last three decades. The significance of the economic reforms of the new Congress Government under Prime Minister Rao, designed to bring India into the mainstream of the international economy, can be seen in historical perspective, if the *modus operandi* of India's earlier sterile economic policy and its contextual rationale are analyzed.

Since Independence, India's policy makers have aimed at a mixed economy with an admixture of public and private sectors but with more weight given to the former at the "commanding heights" of the economy. The resulting economic policy formulation and implementation served the purpose of a mixed economy well for awhile, with a virtual national consensus on major economic issues. The policy framework, however, remained immune from change even as the economy passed through profound structural transformation.

Whenever a change in that policy frame was mooted as in 1964–66, 1981–84, 1985 and 1989, it was assailed on the ground that it would impair national self-sufficiency, arrest the progress of import substitution and the public sector, hurt India's poor, and mortgage India's economic future to the rich Western countries. As a result, policy changes were sacrificed to populist slogans, despite the fact that the earlier policies had neither accelerated economic growth nor contributed to national self-sufficiency.

Indian economic policy was often buffeted over the years for ideological reasons. From the beginning, economic policy and the instruments of its implementation were influenced by a strong perception that there was pervasive market failure in the Indian system and that salvation lay in frequent and decisive government intervention. Moreover, the effectiveness of this interventionist approach was judged only in terms of its "first impact" effects. If industrial licensing was used to determine the output pattern, quantity and composition of imports, it was believed that the final outcome would conform to the original intentions. If foreign exchange was allotted according to a scale of priorities, it was assumed that it would go to the sectors that were designated as high priority. If bank credit was selectively channeled to what were considered to be essential sectors, such as agriculture and small-scale industries, it was concluded that the earmarked sectors would be the real beneficiaries. It was thus assumed that the government would properly identify market failures and also be able to target them effectively.

As it turned out, the actual effects of the government policies were vastly different from the intended ones. Industrial production became diversified but was high-cost and of low quality and could not withstand external competition. Small-scale industries used more capital than labor, contrary to the expectation that they would be major employment-generating, self-sustaining enterprises. In addition, the public enterprises, which were heralded as the instruments of resource mobilization and income distribution, instead drained away the resources mobilized by the government through massive tax efforts. The national self-sufficiency objective remained a pipe dream. Exports stagnated and high-cost import substitution

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resulted in raising imports, thereby perpetuating India's balance-of-payments difficulties. The only beneficial consequences of policies were in several infrastructure activities and public distribution of essential goods to the low-income population — the areas that were most amenable to government participation.

Such was the mesmerizing appeal, however, of such thoughtless state intervention that it took decades before its pernicious consequences and utter futility were widely recognized. In the meantime, parasitic middlemen mushroomed throughout the economy to hijack the gains flowing from the interventionist policies. What went unnoticed for a long time was that the attempt to eliminate market failures by government intervention led to another type of failure — government failure which only compounded the existing one. This outcome of government intervention was a textbook example of the failure to recognize that governmental intervention too has its inefficiencies. As Ronald Coase has argued, the visible hand can be particularly harmful when "the government is not Piqou's ideal but is more like his normal public authority — ignorant, subject to pressure and corrupt" (Coase, 1988 p. 26).

An intriguing question is why a democratic polity like India and its highly gifted economists could not learn from the frustrating experiences of interventionist policies which set back India's economic progress by a few decades. Professor Jagdish Bhagwati, a leading trade and development theorist, and a major scholar of the Indian economy, addresses this question in his most recent book, *India in Transition: Freeing the Economy*, based on his 1992 Radhakrishnan Lectures at Oxford. "The pernicious role of economic theorizing in other ways, based on what turned out to be wrong premises", he argues "must also be reckoned with if the ideas that led to the comprehensive controls over investment and production are to be accurately assessed" (pp. 51–52). These ideas which emanated from the formulations of development economists, among whom Hirschman and Rosenstein-Rodan figured prominently, were embraced enthusiastically by the economists in India who were at the "frontier of developmental thought." Indian economists therefore cannot be absolved of their culpability for India's poor economic performance. As Bhagwati puts it,

> The central role of the economists, their responsibility for India's failings, cannot be lightly dismissed. It is not entirely wrong to agree with the cynical view that India's misfortune was to have brilliant economists: an affliction that the Far Eastern Super-performers were spared. There is a related but distinct proposition that India has suffered because her splendid economists were both able and willing to rationalize every one of the outrageous policies that the government was adopting: by ingeniously constructing models designed to yield the desired answers (p. 54).

The book under review is the latest in the series of books and monographs that Bhagwati has authored and coauthored on development economics in general and the Indian economic policy in particular. (Bhagwati, 1966; Bhagwati and Desai, 1970; Bhagwati and T.N. Srinivasan, 1975, 1993; Bhagwati, 1988). The pioneering work of Bhagwati and Desai in the late 1960s provided the first intellectually coherent analytic framework for assessing Indian planning and industrialization strategies (Bhagwati and Desai, 1970). It demonstrated the crippling inefficiencies that the import-substituting, inward-looking, licensing-infested, public sector-dominated policy framework India had adopted. This important work was followed by the volume coauthored by him and T.N. Srinivasan (1975) demonstrating that there was no convincing way to justify these policies on the grounds that they encouraged savings, entrepreneurship, or innovation either. These findings fell on deaf ears and India's policymakers and influential economists persisted in pursuing cliché-ridden economic policies from which opportunistic politicians, powerful bureaucrats, and businessmen and workers who enjoyed "sheltered markets and squatter's rights" have profited at the cost of the growth of the Indian economy.

The failure of economists reflects in a way the failure of the Indian intellectuals as a class. Most intellectuals chose the painless course of being close to the government instead of risking isolation from it through the formulation of dissenting policy views. The discussion of public policies by the intellectuals thus became a mere ritual to rationalize popular and acceptable ideas, rather than a vehicle for a searching analysis of current policies and for developing independent and superior alternatives (Khatkhate, 1977). Dissent anywhere is costly; the easier course is to go along with the fashion and be rewarded with approbation in the short run. In India, this may have been particularly true as the government was important and all-pervasive in its patronage, largely due to the very policies that needed criticism but were thus safe from it because of a complacent intellectual class.

Bhagwati broke this mold quite emphatically. His two major books (Bhagwati and Desai, 1970; and Bhagwati and Srinivasan, 1975) boldly and decisively attacked the Indian policy framework at its core, profoundly changing the way in which that framework was regarded earlier. In the process, he also changed radically the accommodating image of Indian economists in particular and the Indian intellectuals in general. Disregarding with scorn the pejorative labels fastened on them by the left professionals and the professional left, Bhagwati and his coauthors laid the intellectual foundations of economic policy reforms that India needed to undertake if it was to survive as a functioning democracy and economy and as a prosperous nation holding its own in the international economic order.

They did this through rigorous economic analysis, based not just on abstract principles but also on an acute grasp of concrete Indian reality. Besides, a deep knowledge of the comparative experiences of other developing countries was brought to bear on the analysis of the Indian policy framework and its flawed nature. In fact, Bhagwati's two Indian studies were part of two massive crosscountry projects: the Bhagwati-Desai (1970) book was part of an OECD Project directed by Little, Scitovsky and Scott whereas the Bhagwati–Srinivasan (1975) book was part of the NBER Project directed by Bhagwati and Krueger. (Of relevance in tracing Bhagwati's thinking on India's economic reforms are also his 1967 Frank Graham Lecture at Princeton where concepts, now current in the analysis of trade regimes, such as the "export bias" implied by overvalued exchange rates, were first developed, and his unpublished Report in early 1966 to the Government of India's Ministry of Finance on India's trade regime and the need to rationalize it.)

These important contributions however, were ignored to a point that Bhagwati had despaired of India undertaking the necessary economic reforms in his lifetime. He writes that when he agreed to return to the Indian economic scene for the Radhakrishanan Lectures, he thought that he would be kicking yet again against a "stone wall." But to his surprise and pleasure, the Indian economic and political landscape had radically changed by the time he actually gave these splendid lectures.

The first act of the government that came to power in mid-1991 was to announce radical reform measures exactly along the lines long advocated by Bhagwati and his coauthors. This time "reform by storm has supplanted the reform by stealth of Mrs. Gandhi's time and the reform with reluctance under Rajiv Gandhi" (p. 3). The industrial licensing system has been dismantled, trade barriers are being removed, the tax system is being changed, the financial sector is awaiting a thorough liberalization and major policies toward public sector reforms are being contemplated.

Almost a quarter of a century after Bhagwati broke with the economists in India to urge the reforms, the period during which he (and his coauthors) attracted opprobrium and disdain, Bhagwati is now the subject of adulation. Marginalized and pushed to the periphery, he is now on center stage. He is regarded widely as the intellectual forerunner, the theoretician, of the on-going reforms. The Finance Minister, spearheading the reforms, has declared that India's misfortune was to wait so long to implement what Bhagwati had urged with clarity and foresight two decades earlier. Finally, the prophets are being honored in their own lifetime.

This monograph by Bhagwati harks back to the past and beckons to the future. The former is done with a finesse and flair seldom seen in economic writing. India's lack-luster growth performance, failure in alleviating poverty despite the elimination of poverty being trumpeted as the major goal of national planning strategy, and an almost total atrophy of the public sector are traced to the flawed development model that India adopted.

India's performance was dismal primarily because of the low productivity of investment. In turn, this was to be largely explained by the wrong choice of the policy framework throughout 1952–1991 (with occasional modifications introduced in between but not consistently maintained). Before offering his own diagnosis, Bhagwati confronts the alternative explanations for India's slow growth that have been put forth by the status-quo economists, principally K.N. Raj, and the late Sukhamoy Chakravarty. The main burden of their argument has been that: (a) savings may have been overestimated; (b) income may have been underestimated; and (c) the composition of investment may have shifted efficiently toward sectors with greater capital intensity. While Bhagwati recognizes that these explanations may have some validity, he argues persuasively that they cannot carry the main burden of explaining the low productivity of investment.

His alternative explanation, now accepted by the reformers in the Indian government, is that the faulty policy framework India adopted in the past stifled efficiency and growth until the 1970s, and somewhat less so during the 1980s when the framework consisted of extensive bureaucratic controls over production, investment and, trade; inward-looking trade and foreign investment policies; and a substantial public sector which operated inefficiently. This policy framework was in Bhagwati's view a direct consequence of the predisposition of the planned effort at development toward an excessive and stifling guidance and control of investments flowing directly from the Feldman–Mahalanobis model. Bhagwati, however, is cautious enough not to place all the blame on the ill-suited policy framework alone. He draws attention to a phenomenon that has recently been noted and analyzed with insight by the political scientist Myron Weiner, namely, India's failure to spread primary education and to raise literacy to anywhere near the levels that many other countries have managed (p. 47).

The experiences of the fast growing Far Eastern economies have convincingly shown that there is a close relationship between literacy and growth, and illiteracy which is still pervasive in India accounts as much for low productivity and growth in India as the flawed policy frame. The implications of this are clear: Indian policy makers should not remain complacent by concentrating on economic policy reforms alone. They should go beyond it by focusing on a radical restructuring of the Indian educational system.

Bhagwati is not fully satisfied with what has been done so far in regard to reform policies. He offers a varied menu of policies that needed to be pursued in the future, in regard to controls, the public sector, and trade. He sounds a note of warning that it is not enough "to dismantle either the domestic licensing system or the exchange controls: both had to go," though he recognizes that in actual implementation, some compromises in sequencing are necessary. He suggests a more radical approach for the solution of the problems of public sector enterprises. The policy changes so far made and

> the announcement yet again of the conventional measures to finally improve the working of public enterprises through more autonomy and greater hiring of professionals do not add up to an effective attack on the problem posed by public sector enterprises (pp. 90–91)

and he argues for hard budget constraints and enhanced pressure of competition. Much more is required to be done in the trade policy area. He has only indicated here the broad contours of policies that need to be formulated but he has developed them at length in the Report on *India's Economic Reforms* that he and T.N. Srinivasan presented to the Indian Finance Minister in July 1993 (see also T.N. Srinivasan 1993a and 1993b).

Indian economic reforms have been often criticized by ideologues on the ground that they betray the country's long-cherished concerns with poverty alleviation and national self-reliance and acceptance of a benign role by the state. Bhagwati effectively counters these arguments, not by resorting to *ex cathedra* judgements which his critics often indulge in, but through logical reasoning and empirical analysis. He demonstrates that the very same objectives which India placed prominently on its agenda in earlier years could have been better achieved by economic reforms than by the detailed micromanagement of investment, production and trade.

Consider poverty removal, which rightly agitated Indian policy makers. In their enthusiasm to reduce poverty, they neglected the growth factor which has to remain at the center of such a strategy. His term at the Planning Commission, where Bhagwati began his Indian career in the Perspective Planning Division, had drawn him directly into evolving a strategy for minimum incomes for the poor. This had convinced him of the importance of growth as the key component of an anti-poverty strategy.

> There was no dramatic alternative for raising the poor to minimum incomes except to increase the overall size of the pie. The inter-country differences in the share of the bottom decile where poverty was manifestly rampant, just did not seem substantial enough to suggest any alternative path. The strategy of rapid growth was therefore decided upon, as a consequence of these considerations, as providing the only reliable way of making a substantial, rather than a one-shot, impact on poverty... Growth therefore was indisputably conceived to be an instrumental variable not as an objective *per se*. It is not surprising, therefore, that the assertion to the contrary by institutions and intellectuals who belatedly turned to questions of poverty in the 1970s, have provided many of us who were "present at the creation" to take the backward glance and then turn again to stare coldly and with scorn at these nonsensical claims (p.30).

These words may appear to be harsh but considering what these critics and detractors have done to deter economic reforms directed at enhancing the efficiency of savings and investment, which would have raised the GDP growth rate and helped to make a major dent on poverty, the strictures are well deserved.

Likewise, the ideas which Bhagwati relentlessly developed on economic reforms were mistakenly and perhaps willfully distorted and criticised as an advocacy of *laissez faire*. His nuanced and balanced position on the role of the state is well defined both in his bestselling first book (1966) on underdeveloped countries and even more clearly in the Bhagwati-Srinivasan Report (1993) to the Finance Minister:

> It is indeed true that the proposed reforms are in, every respect, aimed at allowing a greater play for markets where bureaucrats and politicians were wholly dominant in decision making. In short, the reforms are intended to remove the government from areas of economic decision making where our own and more extensive international experience (not ideology) has shown in the post-war period that governments harm, rather than help, the developmental process.
>
> In short, governments tend to do certain things badly and must be kept away from them. But their role continues to be important in other areas, especially in poor countries.
>
> Indeed, even if laissez-faire were the objective of some academic reformers, one need not fear that it will arrive. Governments get elected to do things. To expect that they will oblige by self destructing as per an agenda of laissez-faire is to be utopian at best, and silly, at worst.

This is a clear enough statement of what the state is expected to do, when economic reforms are on the anvil. Therefore, it is no more than a red herring to pose the issues involved in economic reform in terms of state intervention or its absence.

Bhagwati puts down the fascination for excessive and misplaced government interventionism to

> first the inability to trust the market when the scarcities are acute and the tasks set are challenging; and second the failure to understand that market will generally work better than current planning as a resource allocation device (p. 51).

The latter is partly to be explained by the uncritical acceptance of the erroneous arguments of Barone, Lange and Lerner which suggested that centralized market systems would help to calculate prices better. (Even Lange had second thoughts on planning in his own native Poland when he approved of at least partial free market sales by the farms). But all this is a far cry from placing *laissez faire* on the policy agenda.

The inward-looking trade regime that India adopted also was a bad mistake. It prevented India from seizing the gains from trade. The advocates of exchange and trade controls remained anchored to the discredited concept of "export pessimism" even in the face of evidence that

> several countries in East Asia with a much smaller industrial base were not only exporting more manufacturing than India but they were also catching up with India in the absolute size of their manufacturing sector (p. 58).

India's share in world exports, small as it was at the time India launched its industrialization program, shrank even more. Lagging exports together with pressing import requirements, damaged the growth and industrialization process, without national self-sufficiency in sight. If one goes by what the East Asian Tigers accomplished in the same time span during which India labored so much for development, India could have been blessed with self-reliance and more if only it had followed an outward-looking trade regime.

Several of these ideas, stated elegantly in this book, may appear somewhat commonplace today. But that is because they were formulated by Bhagwati himself more than two decades ago in his early writings on poverty and income distribution, on the trade regimes in India and other developing countries, and on much else (including class-bias in education, sex-bias in family and public policy allocations on which he wrote ahead of most in this journal in 1973). While he shared "export pessimism" with all others in India and elsewhere in the early 1960s, he was among the first to change and to emphasize that India could do much better on the export front: an honor that he shares with the Finance Minister himself. The result of this fresh thinking was already evident in Bhagwati's writings in the late 1960s.

As regards emphasis on poverty, Bhagwati had argued as far back as 1966 that minimum income for the poor was the central objective of development (Bhagwati, 1966). Growth was in his view an instrument to alleviate poverty, not an objective in itself. Without growth, poverty could not be attacked in a sustained fashion. Growth was a necessary but generally not a sufficient condition for removing poverty. Is there any doubt that the wisdom of this view has now been universally accepted? Bhagwati's argument that unless growth of income is accelerated with the aid of a policy framework that enhances efficiency in investment and production, poverty will remain entrenched even if programs to attack poverty directly are attempted, has truly come into its own.

The early and powerful demonstration of the inefficient policy framework that produced India's slow growth and the compatibility of efficient policies with, even their necessity for, a rapid implementation of social objectives such as poverty alleviation and economic independence (which can be based only on economic success), will remain the major achievements of Bhagwati and his coauthors. A few quotes are telling:

> India did not plan too much, in certain important ways it just planned inadequately. Physical, cost-benefit ignoring and choice-neglecting planning, combined with detailed regulation of such efficiently determined targets, really proved to be a negation of rational planning. This in itself is a major lesson: and India's experience is of relevance to other developing countries which are at the stage of development and industrialization where enough economic agents and opportunities exist for there to be rational choices among alternative projects and industries within a framework of incentives provided by economic policies (Bhagwati and Desai, 1970, p.500).

> . . . [thus] none of the improvements in the . . . trade, industrialization and related economic policies which we have advocated in this volume are incompatible with the basic objectives of a socialist society, which stresses distributive justice, equality and the eradication of material poverty; indeed these socialist objectives, which we fully share, have been frustrated in many instances by the existing policies and would be better served by the policy changes which we have suggested (Bhagwati and Desai, 1970, p. 500).

These intellectual foundations of the present economic reforms in India, so brilliantly enunciated long ago, effectively challenge the criticism, still voiced in India by economists wedded to old and discredited ideas, that economic reform policies are a recipe for inequality for run-away capitalism, and abdication by the state of its responsibilities for the welfare of the polity.

On the other hand, Bhagwati candidly confesses to having modified his views on two major aspects of his conceptual framework of the economic reform policy contained in his earlier work. The first relates to the public sector's role in the Indian economy and the second to the political economy of policy. He writes that he was "amongst the many who thought in 1950s and 1960s that the public sector enterprises could be operated better" (p.64). Now he is persuaded that the conditions that might make the public sector productive and efficient are "beyond reach at least in India." His optimistic view of the public sector in the early phases of Indian planning was based on the assumption — perhaps legitimate in those days — of the presence of hard budget constraints on the public sector enterprises. With the increasing politicization of economic decision making, however, and consequent microeconomic failure, the budget constraint was softened to an extent that profit generation became the least important consideration in running a public enterprise. His 1970 work already was documenting this problem with public enterprises; now only those wearing blinkers could ignore the problem. Bhagwati has therefore become a more avid convert to either effective privatization or, at minimum, the rapid introduction of private enterprises and foreign competition to force efficiency on public enterprises through enhanced competition.

In regard to the political economy of development, Bhagwati's position seems to have changed much more substantially, however. In Bhagwati (1966) he held the view that economic growth could be faster under totalitarian regimes such as those in the former Soviet Union and China than under democracy. Thus he argued that "the political economy of development poses, in this respect, a cruel choice between rapid (self-sustained) expansion and democratic processes" (p. 204). He now asks: "Can it be argued that India's disappointing economic outcome was a result of trade off between her political preference for democracy and her economic performance?" He answers it negatively, adducing convincing and cogent reasons that the freedom of choice and the whole structure of incentives and disincentives that go with it, prevalent under democracy and its institutions, constitute the core of an efficiency-oriented economic policy frame (see in this context, Desai, 1975).

The earlier belief about the beneficial consequences of the authoritarian regime for economic growth presumed that savings could rise faster under such regimes. The experience over the last three decades has shown, however, that the saving rate could increase rapidly even in democratic countries as it has in India, provided the right kind of incentives are offered. The difference between high and low economic growth is determined more by how efficiently the savings generated are utilized: and here democracy can well be a great advantage.

To conclude, the reforms currently under way in India are already reflecting the ideas that Bhagwati, and his coauthors, formulated and energetically propagated over the years against all odds. The evidence to date indicates that the transition is firmly in place, politically accepted and economically rewarding. But the real significance of Bhagwati's present work, as also his earlier writings, does not lie only in the relevance of the policy framework derived from them; it goes far beyond it. His leadership has broken the sterile mind-set of the Indian intellectuals, and given them a new apparatus of thought with which to look at things in a different way. It is this contribution of Bhagwati which is enduring and has already raised the level of intellectual discourse on public policy in India.

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